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Statement of the Shadow Financial Regulatory Committee on

Risks of Bank Concentration in Commercial Real Estate Lending

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Losses on loans made to finance commercial real estate (CRE) ventures have caused many bank failures in the United States and other countries. For this reason, the Shadow Financial Regulatory Committee applauds the federal banking agencies for addressing high concentrations of CRE loans relative to capital that have emerged at some banks. As Federal Reserve Governor Susan Bies has reported, at banks "with average assets of between $100 million and $1 billion, average CRE concentrations are about 300 percent of total capital," which is twice the levels a decade or two earlier.[1] FDIC Chair Sheila Bair has similarly testified: "At the end of March 2006, commercial real estate loans accounted for more than 42 percent of all loans at institutions with less than $1 billion in assets," compared to 28 percent six years ago.[2] As a result, even minor losses on these types of loans could throw these banks into insolvency.

Insolvency risks are further exacerbated because many banks with high concentrations of CRE loans are newly chartered and are closely held. Empirical research indicates that for approximately four years new banks perform less well than established banks. New banks also tend to hold more of the riskiest type of CRE loans compared to established peer banks. In particular, 21.1% of their assets are nonfarm residential (i.e, commercial) loans compared to 13.2% for established peers, and 8.6% of their assets are construction and development loans, versus 3.9% for their peers.[3]

Furthermore, the collateral for CRE loans tends to be on local properties. This creates the risk that the collapse of geographically narrow real estate markets could result in losses that overwhelm the banks' capital.

Some banks (particularly new ones) have a few stockholders who are managers or who control the managers. Those owners and managers can benefit from taking concentrated risks. They have a strong temptation to bet their banks in the "heads I win, tails the FDIC loses" game, particularly since a large proportion of their deposits are covered by FDIC insurance.

Consequently, the Committee supports the federal banking authorities' jointly issued Guidance on "Concentrations in Commercial Real Estate Lending."[4] The agencies' system of risk-based capital requirements does not take into account concentrations in banks' portfolios of assets that are subject to similar risks. However, as stated in their joint statement: "The Agencies' capital adequacy guidelines note that institutions should hold capital commensurate with the level and nature of the risks to which they are exposed and that institutions with high or inordinate levels of risk are expected to operate well above minimum regulatory capital requirements."[5] We agree with the federal banking agencies that CRE investments, particularly when they are not geographically diversified, present such risks.

The Proposed Guidelines identify principles and procedures of risk management that bankers should employ. These are well-intentioned and should be followed. However, we urge the agencies' examiners and supervisors not just to exhort bankers to establish and follow sensible risk guidelines, but to require incremental capital from banks whose concentrations in risky CRE loans, and indeed, any concentrate risks that threaten to impose losses on the FDIC and, ultimately, on prudently run banks and possibly on taxpayers. Due regard must be paid to assets that pose substantial risks to the bank insurance fund.

We agree with the Guidelines' suggestion that banks increase their use of stress tests to determine the adequacy of their capital. Such tests can determine whether and to what extent banks that hold diversified portfolios of CREs and loans related to home construction and multifamily construction should be considerably less risky, as some industry spokespersons have asserted.[6] The bank agencies' examiners should carefully audit the structure, inputs, and results of stress tests to ensure that banks maintain capital levels adequate to absorb their potential losses.

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[1] Remarks by Governor Susan Schmidt Bies at the Western Independent Bankers Annual CFO & Risk Management Conference, Coronado, CA, June 6, 2006, p. 3.

[2] Statement of Sheila C. Bair … before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S. House of Representatives, September 14, 2006.

[3] Chiwaon Yom, "Recently Chartered Banks' Vulnerability to Real Estate Crisis, FDIC Banking Review, 2005, Vol. 17 No. 2, Table 3 p. 8.

[4] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, January 10, 2006, Proposed Guidance, 71 Federal Register 2302 (January 13, 2006).

[5] Ibid, p. 12.

[6] Testimony of F. Weller Meyer for America's Community Bankers before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S. House of Representatives, September 14, 2006.